

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1917.

No. 422.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR
THE DISTRICT OF MINNESOTA, PETITIONER,

VS.

H. C. HORNBY.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT
OF APPEALS FOR THE EIGHTH CIRCUIT.

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1. The first part of the paper is devoted to the study of the properties of the function $f(x)$ defined by the equation

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Journal of Management Studies, 19(1), 67-80.

Figure 1. The effect of the concentration of the H_2O_2 solution on the amount of the released H_2O from the H_2O_2 -loaded hydrogel. The amount of the released H_2O was measured by the weight difference of the hydrogel before and after the release. The concentration of the H_2O_2 solution was 0.1, 0.2, 0.3, 0.4, 0.5, 0.6, 0.7, 0.8, 0.9, and 1.0 wt. %.

THE UNIVERSITY OF CHICAGO PRESS

Pleas and proceedings in the United States Circuit Court of Appeals for the Eighth Circuit, at the September term, 1916, of said court, before the Honorable Walter H. Sanborn, the Honorable Elmer B. Adams, and the Honorable John E. Carland, circuit judges.

Attest:

[SEAL.]

JOHN D. JORDAN,
Clerk of the United States Circuit Court of
Appeals for the Eighth Circuit.
By E. E. KOCH, Asst. Clerk.

Be it remembered that heretofore, to wit, on the twelfth day of February, A. D. 1916, a transcript of record pursuant to a writ of error directed to the District Court of the United States for the District of Minnesota, was filed in the office of the clerk of the United States Circuit Court of Appeals for the Eighth Circuit in a certain cause wherein E. J. Lynch, collector of internal revenue for the District of Minnesota, was plaintiff in error, and H. C. Hornby was defendant in error, which said transcript, as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, is in the words and figures following, to wit:

1 United States District Court, District of Minnesota, Third Division.

H. C. HORNBY, PLAINTIFF,

v.

E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL revenue for the collection district of Minnesota, defendant.

Pleas before the honorable the judges of the United States District Court for the District of Minnesota.

Be it remembered that on the 28th day of October, A. D. 1915, the plaintiff in the above-entitled cause filed in the office of the clerk of said court a complaint, which said complaint is in the words and figures following, to wit:

Complaint.

United States of America, in the District Court, District of Minnesota, Third Division.

H. C. HORNBY, PLAINTIFF,

v.

E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL revenue for the collection district of Minnesota, defendant.

The above-named plaintiff for his complaint herein, complains of the above-named defendant, and alleges as follows:

I.

This plaintiff is a citizen of the United States, and a resident of the city of Duluth, in the State and collection district of Minnesota, and is and was during the entire year 1914 a married man, living with his wife.

II.

The defendant herein is a resident of the city of St. Paul, in the State and collection district of Minnesota, and the third division thereof, and is the duly appointed and qualified collector of internal revenue of the United States of America for the collection district of Minnesota.

III.

Prior to March 1st, 1915, this plaintiff made, verified, and filed with the defendant herein as collector as aforesaid, in manner and form required by law, and the regulations of the Secretary of the Treasury, a return of his income for the calendar year 1914, in accordance with the requirements of paragraph D, of section 2, of the act of Congress approved October 3, 1913, entitled: "An act to reduce tariff duties and provide revenue for the Government, and for other purposes," the said section of said act being commonly known and always hereinafter referred to as the "income-tax law." Said return stated and showed that in the year 1914 this plaintiff received a gross income amounting to the sum of \$23,293.45, composed of the following items:

Salaries and wages.....	\$10,000.00
Interest on notes, mortgages, bank deposits, and other securities	947.05
Dividends on the stock of domestic corporations subject to the income tax.....	12,336.40

Total.....	\$23,293.45
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Of the above items of gross income, the said return stated and showed that the normal tax provided for by the said income-tax law had been paid at the source on the sum of \$6,000.00, being a portion of the sum received by this plaintiff as salaries and wages, as hereinabove stated.

Said return stated and showed that this plaintiff had and claimed as general deductions from gross income allowable under the provisions of paragraph B of said income-tax law, the following:

All interest paid within the year on personal indebtedness.....	\$3,617.50
All annual State, county, school, and municipal taxes paid within the year (not including those assessed against local benefits).....	369.50

Total.....	\$3,987.00
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Said return further stated and showed that this plaintiff had and claimed as specific deductions allowed in the computing of the normal tax provided for by said income-tax law, the amount of the above income upon which the normal tax had been paid at the source, to wit, the sum of \$6,000.00, and also the amount received by this plaintiff as dividends from the stock of domestic corporations subject to a like tax, to wit, the sum of \$12,336.40.

Said return further stated and showed that this plaintiff had and claimed as a specific exemption allowed by paragraph C of said income-tax law the sum of \$4,000.00.

Said return was a true and correct return of all of the plaintiff's gross income required to be returned or legally taxable under the income-tax law, unless the item of \$17,794.00, being a distribution to this plaintiff in the year 1914 from Cloquet Lumber Company, and more particularly hereinafter referred to and described, or some part thereof, should have been included in plaintiff's gross income.

All statements of and claims for general deductions and specific deductions and exemptions made and stated in said return were

true and correct, and were deductions and exemptions which the plaintiff was and is entitled to under the provisions of paragraphs B and C of said income-tax law, and said deductions and exemptions have never been questioned by the defendant or the Commissioner of Internal Revenue, but have been at all times recognized and accepted as correct, both in character and amount. Said return so made showed that this plaintiff had a net income for the year 1914 of \$19,305.87, and that as the amount of said net income was exceeded by the amount of the specific deductions and exemptions allowed by the income-tax law, for the purpose of computing the normal tax, this plaintiff was liable for no normal tax, and no income tax of any sort for the year 1914, and no assessment was in fact made against this plaintiff by the Commissioner of Internal Revenue, or otherwise, upon said return.

IV.

On or about the 5th day of October, 1915, the Commissioner of Internal Revenue of the United States, having received information that this plaintiff had received in the year 1914 from Cloquet Lumber Company, a domestic corporation subject to the normal tax provided for in said income tax law, distributions amounting in the aggregate to \$17,794.00, and assuming and pretending to act under and by virtue of authority conferred upon him by said income tax law, assessed against this plaintiff an income tax for the year 1914, amounting to \$171.00, and this plaintiff is informed and believes, and therefore alleges, that said assessment was computed and made by said Commissioner of Internal Revenue upon the following basis, and no other:

The said Commissioner of Internal Revenue determined and held that the distributions from Cloquet Lumber Company hereinabove referred to, and more particularly hereinafter described, and re-

ceived by this plaintiff in the year 1914, constituted income derived by this plaintiff from dividends of a domestic corporation subject to tax under said income tax law, within the meaning of the said law, and added the amount of said distributions, to wit, \$17,794.00, to the item of \$12,336.40, described hereinabove and set out by this plaintiff in his return hereinabove described as dividends on the stock of domestic corporations subject to the income tax, and that by said process the said commissioner found and determined that this plaintiff had received as such dividends a total sum of \$30,130.40, and a gross income in the year 1914 amounting to the sum of \$41,087.45. The said commissioner further found that this plaintiff was entitled, under the provisions of paragraph D of said income tax law, to the items of general deductions hereinabove specifically described and stated and claimed by this plaintiff in his said return, amounting in the whole to \$3,987.58. The said commissioner also found and determined that this plaintiff was entitled to specific deductions and exemptions, allowed by paragraphs B and C of said income tax law in computing the normal tax provided for in said law, as follows: Income on which the normal tax had been paid at the source, \$6,000.00; specific exemption allowed by paragraph C of said income tax law, \$4,000.00 (the said two items being two of the items of specific deductions and exemptions claimed and stated by this plaintiff in his said return as hereinabove alleged); and also the sum of \$30,130.40, being the amount of the dividends which the said commissioner found had been received by this plaintiff in the year 1914 from domestic corporations subject to the income tax law, and which the said commissioner treated and held to be a part of this plaintiff's gross income, as hereinbefore alleged, and which amount, if treated as dividends, was deductible for the purpose of computing the normal tax, under the provisions of paragraph B of said income tax law, and was so actually deducted by the said commissioner. As so computed by said Commissioner of Internal Revenue, this plaintiff was found by said commissioner to have received in the year 1914 a net income of \$37,099.87; inasmuch as the specific deductions and exemptions found and allowed by the said commissioner under the provisions of paragraphs B and C of said income tax law for the purpose of computing the normal tax exceeded the net income of this plaintiff, no normal tax was assessed against this plaintiff by the said commissioner; but as the net income of this plaintiff as so computed by said commissioner exceeded the sum of \$20,000.00, said commissioner decided and found that this plaintiff was liable for an additional or supertax at the rate of one per cent upon the amount by which said net income so computed exceeded the sum of \$20,000.00, to wit, the sum of \$17,099.87; and upon this basis and theory, and upon such a computation of the income of this plaintiff for the year 1914, and not otherwise, the said Commissioner of Internal Revenue assessed against the plaintiff the tax of \$171.00 hereinabove referred to.

V.

On or about the 9th day of October, 1915, the defendant herein, as collector as aforesaid, served upon this plaintiff a written notice and demand, notifying this plaintiff that there had been assessed against him the tax of \$171.00 hereinabove described, and demanding of this plaintiff the payment of said tax, and in and by said notice and demand the defendant herein threatened, if the said tax was not paid, to enforce the collection thereof with the penalties by said income tax law provided, and in manner and form as by law provided.

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VI.

Thereupon and in order to prevent the accrual of penalties and distraint of plaintiff's property, on or about the 9th day of October, 1915, the plaintiff paid to the said defendant as United States collector as aforesaid, said sum of \$171.00, being the amount of the tax assessed as aforesaid, under duress and under written protest, which protest is in the words and figures following, to wit:

ST. PAUL, MINN., October 9th, 1915.

To the Secretary of the Treasury, the Commissioner of Internal Revenue, and E. J. Lynch, Collector:

There has this day been served upon me a notice of assessment against me of an individual income tax of \$171.00 for the tax year 1914, together with a demand for payment of said sum.

You will take notice that I pay said tax following such notice and demand and under protest and duress, and not otherwise, and protest against the assessment and collection of said tax and all thereof, on the ground that the assessment thereof is not based upon net income received by me in the year 1914 or at any other time, which was or is taxable under the law.

And I request that there be noted upon the receipt for said taxes, and upon the proper records of your respective offices, the fact that I pay said tax under protest.

(Signed) H. C. HORNBY.

VII.

Thereafter and on or about the 9th day of October, 1915, this plaintiff made and filed with the defendant herein, and the Commissioner of Internal Revenue, an application and appeal for the refund of said sum of \$171.00 so paid under protest and duress, in manner and form as provided in section 3926 of the Revised Statutes of the United States, the provisions of the law in that regard, and the regulations of the Secretary of the Treasury established in pursuance to said law, and thereafter, and on or about the 12th day of October, 1915, the plaintiff's said application and appeal were rejected and denied in toto by the said Commissioner of Internal Revenue.

VIII.

The said tax of \$171.00 hereinabove described, assessed, demanded, and paid as hereinbefore alleged, was wholly illegal and void, for the following reasons and by virtue of the following facts, which this plaintiff hereby alleges to be true:

1. The sum of \$17,794.00 hereinabove referred to and received by this plaintiff in the year 1914, which sum was by the Commissioner of Internal Revenue as hereinabove alleged treated as and held to be income derived from dividends received by the plaintiff on the stock of a domestic corporation, was received by this plaintiff in the year 1914 as distributions from Cloquet Lumber Company, under circumstances hereinafter alleged.

2. The said Cloquet Lumber Company is a corporation created, organized, and existing under and by virtue of the laws of the State of Iowa, and at all times herein mentioned, admitted, and authorized to transact business in the State of Minnesota.

3. The said Cloquet Lumber Company was organized for the purpose of and had the power to buy, own, and hold real property, and particularly timberlands in the State of Minnesota, and to manufacture and sell lumber and lumber products; also to buy, own, and hold capital stock of other corporations engaged in like business. The said company has for the past 31 years been engaged in the business of manufacturing lumber at the city of Cloquet, in the State of Minnesota, and of buying, holding, and owning timberlands from which, to a large extent, said company has and does cut the logs which it has manufactured into lumber, and in the course of said business, and as incidental thereto, the said company has acquired other assets connected with or incidental to its said business, including the capital stock of other corporations.

4. The authorized capital stock of said Cloquet Lumber Company was for a long time prior to March 1st, 1913, \$1,000,000.00, divided into 10,000 shares of the par value of \$100.00 each. Long prior to the 1st day of March, 1913, all of said capital stock had been subscribed and paid for at par value in cash, and was outstanding. Prior to the date last hereinabove mentioned, and at all times thereafter, this plaintiff was the owner of 434 shares of said stock of said company, of the par value of \$43,400.00. Of said shares this plaintiff had acquired 154 shares many years ago at their par value, but the remainder of said shares, to wit, 280 shares, this plaintiff had purchased on or about January 1st, 1904, and paid therefor the sum of \$280.00 per share.

5. The said Cloquet Lumber Company in the early years of its existence, and of its business, and many years prior to March 1st, 1913, invested a large portion of its capital in timbered lands and in standing timber or stumpage, and the said timbered lands and timber or stumpage so acquired by said company, and which was still unused and unused by said company on that date, had greatly increased in

value, and was of the fair value on that date of many times the amount which had been paid for said property by said company. In the early years of its business the said company paid no dividends and made no distributions to its stockholders, but had reinvested all of the profits made by said company in its business, and all of the money realized by it in the process of converting its standing timber into lumber and selling the same for money, in other timber lands or stumpage, and in other assets connected with and incidental to its business, including the capital stock of other [corporation] engaged in a like business. On March 1st, 1913, the said company was possessed of assets other than undivided profits, consisting of property used in its business, or connected therewith, or incidental thereto, of the fair and actual market value of not less than four times the par value of its capital stock; in other words, said company had on said date a large actual surplus. That a considerable part of the property and assets so acquired by said company, and owned by it on March 1st, 1913, consisted of timbered lands and timber of great value, and of \$110,000.00 par value of the capital stock of Johnson-Wentworth Company, a corporation, hereinafter more particularly described.

6. On March 1st, 1913, the timber upon the timbered lands and the timber or stumpage so owned by said Cloquet Lumber Company was of the fair and actual market value of \$10.00 per thousand feet, board measure, scaled by what is known as a straight and sound scale, and said timber or stumpage had been of said fair and actual market value for at least four years prior to said date; and the above described stock of Johnson-Wentworth Company so owned by said company was of a real and actual value of not less than \$400,000.00, and that the real and actual value of said stock on the 1st day of January, 1909, was far in excess of its said value on March 1, 1913. On said 1st day of March, 1913, the stock of said Cloquet Lumber Company owned by this plaintiff was of the real and actual value of not less than \$150,000.00.

7. The said Cloquet Lumber Company has purchased no standing timber since March 1st, 1913, [not] for several years prior thereto, and there is practically no standing timber or stumpage in the territory which is available to or which can be purchased by, the said company other than that owned on said date by said company. On March 1st, 1913, and in the year 1914, and for several years prior thereto, it was the business policy and intention of the said company, said policy and intention being made necessary by the fact that no new timbered lands or timber was available to it in its territory, to make no new investments, either in timber or timbered lands, or otherwise, but to distribute to its stockholders as fast as its standing timber and other capital assets were converted by it into money the monies received therefor, in addition to whatever profits were made and received by the company. So far as the manufacturing business of said company is concerned, the same must neces-

early, on account of the fact that the timber which it owns and the timber which is available to it in its territory, being its raw material for its manufacturing purposes, is limited, cease within the next five or six years.

8. Said Cloquet Lumber Company in the year 1914 received and had a total net profit and income of \$242,318.27, and no more. Said company also received in the year 1914 monies available for distribution to its stockholders other than its said net income and profit amounting to the sum of \$410,000.00. The said sum of \$410,000.00 was realized and received by said company in the manner and from the sources more particularly described in the next two succeeding paragraphs.

9. Of said sum of \$410,000.00, the sum of \$258,000.00 was received by said Cloquet Lumber Company as the proceeds of the conversion into money during the year 1914 of standing timber or stumpage owned by said company on March 1st, 1913, and for many years prior thereto. The amount so realized by said company in each year and in the year 1914 was calculated as follows: The profit made and received by said company in its business of manufacturing and selling lumber in any calendar year is computed by deducting (among other items of actual expense) from the net amount received for sales of lumber during the year the total cost in pile of the lumber sold. The said total cost in pile of the lumber sold is partly based and computed upon the total manufacturing cost of lumber manufactured during the year, into which there is charged the actual cost to said company of the logs manufactured into lumber during that year. The total cost of the logs manufactured into lumber each year is arrived at by charging up (in addition to other items of actual cost and expense) the logs cut from timber owned by said company at the rate of \$10.00 per thousand feet, board measure, on a straight and sound scale, which same value was, as hereinabove alleged, the actual market value of the standing timber and stumpage owned by said company on March 1st, 1913. The net profits of said company from its manufacturing and selling operations in any calendar year is therefore arrived at on the basis of charging as an element in manufacturing cost the actual value (as of March 1st, 1913) of the standing timber owned by the said company and consumed by it during the year, to-wit, at \$10.00 per thousand feet, board measure, straight and sound scale, as above alleged, and the total amount realized in each year by said company from the sale of lumber over and above the net profits on said operations, computed as hereinabove stated, is the amount realized and received by said company in that year from said conversion of its standing timber.

10. The balance of the sum of \$410,000.00 hereinabove referred to, received by said Cloquet Lumber Company during the year 1914 over and above the net profits received by it, to wit, the sum of \$52,000.00, was received in the year 1914 by the said company in the form of a distribution from Johnson-Wentworth Company to its

stockholders, pro rata, out of the surplus of said Johnson-Wentworth Company, as said surplus existed prior to March 1st, 1913, and prior to January 1st, 1909, said money so distributed by said Johnson-Wentworth Company having been received by the latter company during the year 1914, by a conversion into money of capital assets which were owned by said company both on January 1st, 1909, and March 1st, 1913.

And in that behalf, plaintiff alleges that Johnson-Wentworth Lumber Company is a corporation created, organized, and existing under and by virtue of the laws of the State of Minnesota, and that the said company has been for more than 25 years last past engaged in the business of manufacturing and selling lumber in the city of Cloquet, and State of Minnesota, and of owning, holding, and cutting timbered lands and timber or stumpage used by said Johnson-Wentworth Company as its raw material for the manufacture of lumber. That said Johnson-Wentworth Company has now, and for many years prior to March 1st, 1913, had, an authorized capital stock of \$320,000.00, all of which had been subscribed and paid for at its par value, and issued. Since about the year 1902 the Cloquet Lumber Company has been the owner of one-half of the capital stock of the said Johnson-Wentworth Company, to wit, 1,100 shares of the par value of \$110,000.00, for which stock said Cloquet Lumber Company paid more than \$1,000,000.00. In the earlier years of its existence in business the said Johnson-Wentworth Company invested a large amount of its capital in timbered lands and standing timber, or stumpage, in the State of Minnesota, for the purpose of cutting and using the timber thereon as raw material for the manufacture of lumber. In the earlier years of its business said Johnson-Wentworth Company paid no dividends to its stockholders, but invested a large part not only of its earnings and profits from year to year, but also of the amount realized by it from the conversion into money of its standing timber and stumpage, in other and further timbered lands and standing timber or stumpage. That the original standing timber and stumpage originally purchased by Johnson-Wentworth Company, and which it still held, and the other standing timber so

10 purchased by it, greatly increased in value from year to year until both on the 1st day of January, 1909, and on the 1st day of March, 1913, the assets of said Johnson-Wentworth Company, consisting mostly of said standing timber, were of a value very greatly in excess of the par value of its capital stock. In other words, the said Johnson-Wentworth Company was both on January 1st, 1909, and March 1st, 1913, possessed of a very large actual surplus over and above the amount of its capital stock, said surplus being invested in and consisting to a very large extent of standing timber and timbered lands owned by said Johnson-Wentworth Company on the dates last hereinabove mentioned, and on both said dates the stock of said company owned by said Cloquet Lumber Company was worth several times its par value. In the year 1914, and for several years prior thereto, the business policy and intention of said Johnson-

Westworth Company, necessitated by the fact that there was no more timber left in territory available to it which it could acquire, was not to invest in any more timber or other assets but to distribute to its stockholders, as fast as received by it, the monies realized from a conversion of its capital assets as well as the profits made and received by it in its business. In the year 1914 said Johnson-Westworth Company made and received net profits and income amounting to the sum of \$150,349.23, and no more. During the same year said company received monies, applicable to distribution to its stockholders, and over and above its said net profits and income, in a sum exceeding \$104,000.00. That said sum of \$104,000.00 was received and realized by said Johnson-Westworth Company in the year 1914 out of conversion by it into money of capital assets owned by it both on January 1st, 1909, and March 1st, 1912, to wit, standing timber owned by it on said dates, and by it converted into lumber and sold in the year 1914. That the real and actual market value of the standing timber so converted by it into money in the year 1914 was, both on the 1st day of January, 1909, and on the 1st day of March, 1912, at least the sum of \$10.00 per thousand feet, board measure, scaled by what is known as a straight and sound scale. That the amount realized and received by the Johnson-Westworth Company in the year 1914 out of such conversion of its said capital assets, was determined and arrived at by identically the same method, and in identically the same way, as Cloquet Lumber Company arrived at the amount realized by it in the year 1914 from a conversion of its standing timber into money during the same year, as hereinabove specifically alleged—that is to say, standing timber or stumpage owned by the said Johnson-Westworth Company, was charged into manufacturing cost on the basis of \$10.00 per thousand feet, board measure, scaled as aforesaid.

During the year 1914 Johnson-Westworth Company distributed to its stockholders, pro rata, the sum of \$160,000.00, out of net profits made by it in the year 1914 and undivided profits carried over by it from the previous year, and also distributed to its stockholders pro rata the further sum of \$104,000.00 out of the monies so received by it from the conversion into money during the year 1914 of its capital assets, as hereinabove alleged. That of such distributions, and as the owner of one-half of the capital stock of the Johnson-Westworth Company, the Cloquet Lumber Company received total distributions of \$122,000.00, of which it was notified by the Johnson-Westworth Company that the sum of \$60,000.00 was paid out of the earnings of said company, and the sum of \$62,000.00 out of surplus which had existed both on January 1st, 1909, and March 1st, 1912, being the amount of money realized as above alleged by said Johnson-Westworth Company, on capital assets owned by it on those dates. The Cloquet Lumber Company credited the said sum of \$60,000.00 to its profit-and-loss account, and the same is a portion of its net profits for the year 1914 hereinabove described, amounting to the sum of \$242,218.97, and the balance of said distributions, to wit, the sum of \$62,000.00, was credited by the Cloquet Lumber Company

to its surplus account, and is a portion of the \$410,000.00 hereinabove described, and in said year distributed to its stockholders, as hereinafter more particularly alleged. The amount of said distributions of surplus by said [Johnson]-Wentworth Company, to wit, \$101,000.00, was charged by that company on its books to its surplus account, and by said distribution the capital assets of said company and its surplus were permanently reduced; and the value of the stock of said company owned by the Cloquet Lumber Company, was reduced by the amount of said distribution, which was received by said Cloquet Lumber Company, to wit, the sum of \$32,000.00.

11. In the year 1914 Cloquet Lumber Company distributed to its stockholders, pro rata, a total sum of \$650,000.00. That of said distributions, the said company informed its stockholders, including this plaintiff, in writing, as was the fact, that the sum of \$340,000.00, or 52% upon its capital stock, was distributed out of the net earnings and profits of the company for the current period, and that \$410,000.00, or 63% upon its capital stock, was distributed out of the surplus which existed on March 1st, 1913, being monies realized during the year 1914 by said company out of conversion by it of capital assets owned by it on March 1st, 1913. Of said distributions this plaintiff received, as the owner of 434 shares of the capital stock of said company, the sum of \$10,416.00 out of said distributions of net profits of said company and the sum of \$17,794.00 out of said distributions of surplus.

The amount so distributed by Cloquet Lumber Company to its stockholders in 1914 out of its surplus was charged on its books to its surplus account, and the said distribution permanently reduced the capital assets and the surplus of said company by the amount of said distribution, to wit, \$410,000.00; and by said distribution of surplus the value of the plaintiff's shares of stock in said company was permanently reduced by the portion of said distribution received by him, to wit, \$17,794.00.

12. In his return of net income hereinabove described this plaintiff included as a portion of his gross income, and as a portion of the sum of \$12,396.40 returned by this plaintiff as hereinabove alleged as dividends on the stock of domestic corporations subject to the income tax, the said sum of \$10,416.00, but that this plaintiff did not, in his said return, include the sum of \$17,794.00 received by him as hereinabove alleged. It was said sum of \$17,794.00 received by this plaintiff as hereinabove alleged that the Commissioner of Internal Revenue included as gross income of this plaintiff, as more particularly hereinabove alleged, in computing the net income of this plaintiff for the year 1914, and in assessing the tax of \$171.00 hereinabove described, and unless said sum of \$17,794.00 is included in the plaintiff's gross income for the year 1914, then this plaintiff had no net income in said year which is taxable under the terms and provisions of the income-tax law. And in that behalf this plaintiff alleges that the receipt by him of said \$17,794.00 was not the receipt of either net or gross income within the meaning of said income-tax law, but constituted and was a return to him of capital assets owned by him at the date of the taking effect of said income-tax law, to wit, March

1st, 1913, and that within the intent and meaning of said income-tax law such distribution was not income which was taxable in itself, nor was it income which could be taken into account in computing or determining the net taxable income of an individual. And this plaintiff further alleges that even if within the meaning of said income-tax law the said item of \$17,894.00 constituted a portion of the gross income of this plaintiff for the year 1914, nevertheless, and in that event he was entitled to, and there should have been allowed him as a deduction from gross income, either as a loss actually sustained during the year or as a reasonable allowance for the exhaustion of property, under the provisions and within the meaning and intent of paragraph B of said income-tax law, the amount by which the actual value of the capital stock of this plaintiff in said Cloquet Lumber Company on March 1st, 1913, was reduced, depreciated, and destroyed by the distribution made to this plaintiff and to all of the stockholders of said Cloquet Lumber Company, as hereinabove alleged, to wit, the sum of \$17,794.00. And this plaintiff further alleges that if said deduction from gross income had been allowed to this plaintiff by the Commissioner of Internal Revenue in computing the net income of this plaintiff for the year 1914, this plaintiff would have had no net income for said year which was taxable under the income-tax law. And this plaintiff further alleges that if within the true intent and meaning of said income-tax law the said sum of \$17,794.00 constituted income within the meaning of said law, which was to be considered in computing the net taxable income of an individual thereunder, and if, within the true intent and meaning of said law, no deduction is allowed this plaintiff for loss or depreciation of his capital assets as hereinabove alleged, then said income-tax law was and is to that extent unconstitutional and void, and in contravention of the provisions of the Constitution of the United States, and particularly the following portions thereof: Article I, section 2, clause 3; Article I, section 9, clause 4; and the 16th amendment to the Constitution, for the reason that said law attempts to tax that which is not income within the meaning of said 16th amendment, but is property, and the tax imposed by said law is a direct tax not apportioned among the several States according to their respective numbers.

IX.

That by reason of the facts hereinbefore stated and alleged, there is due and owing to this plaintiff from the defendant herein, the amount of the tax hereinabove described, assessed, demanded and paid, as hereinabove alleged, to wit, \$171.00, with interest thereon from the 9th day of October, 1915.

Wherefore, plaintiff demands judgment against the defendant herein, for the sum of \$171.00, with interest thereon from October 9th, 1915, and for his costs and disbursements herein incurred.

CLIFF & MACARTNEY &

HAROLD J. RICHARDSON,

Attorneys for Plaintiff.

STATE OF MINNESOTA,

County of Ramsey, ss:

A. W. Clapp came before me personally, and being duly sworn, doth say, that he is one of the attorneys for the plaintiff in the above-entitled action; that the foregoing pleading is true to the best of his knowledge, information, and belief; and that the reason why this verification is not made by said plaintiff is that said plaintiff is absent from the county of Ramsey in which county this affiant and all plaintiff's attorneys reside.

A. W. CLAPP.

14 Subscribed and sworn to before me this 28th day of October,
A. D. 1915.

[NOTARIAL SEAL.]

KENNETH BRILL,

Notary Public, Ramsey County, Minn.

My commission expires June 15th, 1922.

(Endorsed:) Filed in the District Court on Oct. 28, 1915.

Summons and marshal's return.

Return on service of writ.

UNITED STATES OF AMERICA,

District of Minnesota, ss:

I hereby certify and return that I served the annexed summons on the therein-named E. J. Lynch, as United States Collector of Internal Revenue, by handing to and leaving a true and correct copy thereof with him personally at St. Paul in said district on the 29th day of October, A. D. 1915.

WILLIAM H. GREENHAW,

*U. S. Marshal.*By W. W. RICH, *Deputy.**Summons.*

UNITED STATES OF AMERICA,

District of Minnesota, ss:

In the District Court of the United States for the District of
Minnesota, Third Division.

H. C. HORNBY, PLAINTIFF,

against

E. J. LYNCH, as UNITED STATES COLLECTOR OF INTERNAL
revenue for the collection district of Minnesota, de-
fendant.

} *Summons.*

*The President of the United States of America to the defendant above
named, greeting:*

You are hereby summoned and required to answer the complaint
in this action, which has been filed in the office of the clerk of this
court in the city of St. Paul, in said district of Minnesota, third

division, and file your answer in said clerk's office within twenty days after the service hereof, excluding the day of such service, and if you fail to answer the complaint as aforesaid the plaintiff will take judgment against you for the sum of one hundred and seventy-one dollars (\$171.00), with interest thereon from October 9th, 1915, and for his costs and disbursements of this action.

For the marshal of the United States for the district of Minnesota to execute.

Witness the Honorable Page Morris, judge of the District Court of the United States of America, for the district of Minnesota, at St. Paul in said district, this 29th day of October, in the year of our Lord one thousand nine hundred and fifteen, and of our independence the one hundred and fortieth year.

CHARLES L. SPENCER, Clerk.
By MARGARET L. MULLANE, Deputy.

CLAPP AND MACARTNEY and
HAROLD J. RICHARDSON,
HAROLD J. RICHARDSON,
Plaintiff Attorney, St. Paul, Minn.

(Entered:) Summons. Filed November 4, 1915. Charles L. Spencer, clerk.

Demurrer to complaint.

Now comes the defendant, and demurs to the complaint in the above-entitled action, on the ground that the same does not state facts sufficient to constitute a cause of action.

ALFRED JACQUES,
United States Attorney District of Minnesota,
For the Defendant.

(Entered:) Filed in the District Court on Dec. 20, 1915.

Record entry of hearing of demurrer to complaint.

December Term, 1915. December 20, 1915. Before Judge Booth.

By agreement of the attorneys for the parties to the above-entitled cause, said cause is brought on this day to be heard upon the demurrer of said defendant to the complaint herein, Messrs Clapp & Macartney appearing as attorneys for said plaintiff, and Alfred Jacques, Esq., appearing as attorney for said defendant.

Argument upon said demurrer is heard in part, and is continued for further hearing until the following day.

Record entry of hearing of demurrer to complaint, December 20, 1915. Demurrer overruled.

Pursuant to continuance, further argument on the demurrer in the above-entitled cause is this day had, the parties to the said cause

appearing by their same attorneys, respectively, as on the preceding day. And said arguments having been concluded, and said demurrer submitted to and duly and maturely considered by the court, it is by the court—

Ordered, that the demurrer of the defendant to the complaint herein be and the same hereby is overruled.

An exception to this order is allowed to defendant.

16 *Judgment. United States District Court, District of Minnesota, Third Division.*

Term minutes, December Term, A. D. 1915, January 31, 1916.

Present: Honorable Wilbur F. Booth, judge.

H. C. HORNBY, PLAINTIFF,

v.

E. J. LYNCH, AS UNITED STATES COLLECTOR OF INTERNAL REVENUE for the collection district of Minnesota, defendant. No. 574.

It appearing to the court that the above-named defendant, E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, has been duly served with process, and that on the 21st day of December, A. D. 1915, a demurrer of said defendant to the complaint herein was overruled by this court, and that more than twenty days have elapsed since the day said demurrer was so overruled, and that said defendant has failed to answer or further plead to said complaint. Now, on motion of Messrs. Clepp and Macartney, attorneys for said plaintiff, a default is hereby entered against said defendant, and it is by the court—

Considered, ordered, and adjudged that the above-named plaintiff H. C. Hornby, do have and recover of and from said defendant E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, the sum of one hundred and seventy-one dollars (\$171.00), with interest thereon from the 9th day of October, A. D. 1915, at the rate of 6% per annum, amounting to \$3.19, as demanded in said complaint, and being in all the sum of one hundred and seventy-four and 19/100 dollars (\$174.19), together with the costs and disbursements of said plaintiff in this behalf expended, and taxed at the sum of \$17.41; and that said plaintiff do have execution therefor.

Bill of exceptions.

Filed February 5, 1916. December 21st, 1915.

Present: Honorable Wilbur F. Booth, Judge.

The above entitled cause of action came on before the court at the city of St. Paul, in said State, district, and division, on the 20th and 21st days of December, 1915, for argument on the demurrer to the complaint interposed by the defendant—on the ground that the complaint fails to state facts sufficient to constitute a cause of action.

Messrs. Clapp & [McCartney], H. Oldenburg and H. J. Richardson appearing as attorneys for plaintiff, and Alfred Jacques, United States attorney, appearing as attorney for defendant.

17 And the court, having listened to the arguments of the respective counsel and being fully advised in the premises, after due consideration had did enter an order and decision in all things overruling the demurrer of the defendant.

Whereupon the defendant duly excepted to the above order, decision, or ruling of the court overruling the demurrer of the defendant to the complaint of the plaintiff, which exception was duly allowed by the court, and more than twenty days having elapsed after the day said demurrer was overruled, and the said defendant having failed and declined to answer or further plead to said complaint, on the 31st day of January, 1916, judgment was entered in said action as follows:

"It is by the court considered, ordered, and adjudged that the above-named plaintiff H. C. Hornby do have and recover of and from said defendant E. J. Lynch, United States collector of internal revenue for the collection district of Minnesota, the sum of one hundred seventy-one dollars (\$171.00), with interest thereon from the 5th day of October, A. D. 1915, at the rate of 6% per annum, amounting to \$3.19, as demanded in said complaint, and being in all the sum of one hundred seventy-four and 19/100 dollars (\$174.19), together with the costs and disbursements of said plaintiff in this behalf expended, and taxed at the sum of \$17.41; and that said plaintiff do have execution therefor."

Certificate to bill of exceptions.

The foregoing document having been examined and having been found to contain a full, correct, and complete statement of the proceedings had at the trial of the action above entitled, it is hereby allowed and signed as the bill of exceptions of the defendant in said action.

Dated this 3rd day of February, 1916.

WILSON F. BOOTH, Judge.

It is hereby stipulated, by and between the parties to the above-entitled action, that the above bill of exceptions proposed by the defendant may be allowed and signed by the judge of said court as and for the bill of exceptions in said action, and may be filed as the bill of exceptions of the defendant in said action.

Dated February 2nd, 1916.

CLAPP & MACARTNEY,
H. OLDENBURG,
H. J. RICHARDSON,
Attorneys for Plaintiff.
ALFRED JACQUES,

United States Attorney, for the Defendant.

(Endorsed:) Filed in the district court on February 5, 1916.

Assignment of errors.

Now comes the defendant in the above-entitled cause and files the following assignment of error upon which it will rely in its prosecution of the appeal in the above-entitled cause, bringing up for review the judgment made and entered in said court on the 31st day of January, 1916:

I.

That the United States District Court for the District of Minnesota, Third Division, erred in overruling the demurrer interposed by the defendant to the complaint of the plaintiff in the cause.

Wherefore defendant asks that said judgment be reversed and that said District Court for the District of Minnesota, Third Division, be ordered and directed to enter judgment in favor of the defendant or to grant a new trial of said cause.

ALFRED JAGUES,

United States Attorney, for the Defendant.

(Endorsed:) Filed in the district court on Feb. 5, 1916.

Petition for and order allowing writ of error.

To the honorable District Court of the United States, District of Minnesota, Third Division:

The defendant in the above-entitled action, feeling himself aggrieved by the judgment rendered and entered in the above-entitled action on the 31st day of January, 1916, comes now by his attorney and petitions your honorable court for an order allowing said defendant to prosecute a writ of error to the United States Circuit Court of Appeals for the Eighth Circuit of the United States, according to the laws of the United States in that behalf made and provided, and also your petitioner prays that the transcript of all the proceedings in said cause, together with the assignments of error filed herein, be duly authenticated and with the same be sent to the Circuit Court of Appeals.

ALFRED JAGUES,

United States Attorney, for the Defendant.

Order allowing writ of error.

Upon motion of Alfred Jagues, United States attorney and attorney for the defendant in the above-entitled cause, and upon the filing of the foregoing petition for a writ of error, and upon the filing of the assignments of error herein,

It is by the court hereby ordered that the writ of error be, and the same is hereby, allowed, to have reviewed in the United States

19 Circuit Court of Appeals for the Eighth Circuit, the said judgment entered herein on the 31st day of January, 1916. It is further ordered that all further proceedings in this court be suspended and stayed until the determination of said writ of error. Dated this 5th day of February, 1916.

WILLIAM F. BOOTH, *District Judge.*

(Endorsed:) Filed in the district court on Feb. 5, 1916.

Præcipe for transcript and election as to printing.

To Charles L. Spencer, clerk of said court:

In the above-entitled cause please make and forward to the clerk of the United States Circuit Court of Appeals, Eighth Circuit, at St. Louis, Missouri, as and for a transcript of the record on the writ of error from said Circuit Court of Appeals, copies of the following papers:

Complaint, summons, demurrer, record of hearing on demurrer, order overruling demurrer, judgment for plaintiff, bill of exceptions, assignment of errors and prayer for reversal, petition for writ of error and order allowing same, and this præcipe and election.

The defendant herein files this, his notice of election to take and file said transcript in said Circuit Court of Appeals, and that the same be printed under the supervision of the clerk of said Circuit Court of Appeals, under its rules.

Dated February 4, 1916.

ALFRED JACOB, JR.

United States Attorney and Attorney for Defendant.

(Endorsed:) Filed in the District Court on Feb. 5, 1916.

(Citation.)

To H. C. Hornby, plaintiff above named:

You are hereby cited and admonished to be and appear in the United States Circuit Court of Appeals for the Eighth Circuit of the United States, at the city of St. Louis, Missouri, sixty days from and after the date this citation bears date, pursuant to a writ of error filed in the clerk's office of the United States District Court, District of Minnesota, Third Division, wherein H. C. Hornby is plaintiff and E. J. Lynch, collector of internal revenue for the district of Minnesota, is defendant, to show cause, if any there be, why the judgment rendered against the defendant and in said writ of error mentioned should not be corrected, and why speedy justice should not be done the parties in that behalf.

Witness the Honorable Willbur F. Booth, judge of the United States District Court, this 5th day of February, 1916.

WILLIAM F. BOOTH, *District Judge.*

30

Due service of the foregoing citation and receipt of copy thereof is hereby admitted this 7th day of February, 1918.

CHART & MAE LORRY;
H. OLDENBURG;
H. J. RICHARDSON,
Attorneys for Plaintiff.

(Endorsed:) Filed in the district court on Feb. 7, 1918.

Clerk's certificate to transcript.

I, Charles L. Spencer, clerk of the United States District Court for the District of Minnesota, do hereby certify and return to the honorable the United States Circuit Court of Appeals, Eighth Circuit, that the foregoing, consisting of 32 pages, numbered consecutively from 1 to 32, is a true and complete transcript of all the records, process, pleadings, orders, judgment, and all other proceedings in the within-entitled cause, and of the whole thereof, as appears from the original records and files of said court, and in accordance with a precept for such transcript, a copy of which is included therein; and I do further certify and return that I have annexed to said transcript and included within the paging the original citation, together with the admission of service thereof.

In witness whereof I have hereunto set my hand and affixed the seal of said district court, at St. Paul, in said district, this 10th day of February, A. D. 1918.

CHARLES L. SPENCER, *Clerk.*

(Seal U. S. Dist. Court, Dist. of Minnesota, Third Division.)

Filed Feb. 12, 1918.

JOHN D. JORDAN, *Clerk.*

(Writ of error.)

UNITED STATES OF AMERICA, ss:

The President of the United States of America, to the honorable the judges of the District Court of the United States for the District of Minnesota, Third Division, greeting:

Because in the records and proceedings, as also in the rendition of the judgment of a plea which is in the said district court before you, at the December term, 1915, thereof, between H. C. Hornby, plaintiff, and E. J. Lynch, collector of internal revenue, defendant, manifest error hath happened, to the great damage of the said E. J. Lynch, collector of internal revenue, as by his complaint appears,

We, being willing that error, if any hath been, should be duly corrected and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then, under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the United States Circuit Court of Appeals for the Eighth Circuit, together with this writ, so that you have the said record and proceedings aforesaid at the city of St. Louis, Missouri, and filed in the office of the clerk of the United States Circuit Court of Appeals

for the Eighth Circuit on or before the 5th day of April, 1916, to the end that the record and proceedings aforesaid, being inspected, the United States Circuit Court of Appeals may cause further to be done therein to correct that error, what of right and according to the laws and customs of the United States should be done.

Witness the Honorable Edward D. White, Chief Justice of the United States, this 5th day of February, A. D. 1916.

Issued at office in St. Paul, Minnesota, with the seal of the District Court of the United States for the District [or] Minnesota, third division.

(Seal U. S. Dist. Court, Dist. of Minnesota, third division.)

CHARLES L. SPENCER,

*Clerk of the District Court of the United States
for the District of Minnesota.*

Allowed by WILBUR F. BOOTH, Judge.

Filed February 5, 1916.

CHARLES L. SPENCER, *Clerk.*

UNITED STATES OF AMERICA,

District of Minnesota, third division, ss.

In obedience to the command of the above writ, I herewith transmit to the United [Stated] Circuit Court of Appeals for the Eighth Circuit, a duly certified transcript of the record and proceedings in the within entitled cause, with all things concerning the same.

In witness whereof I hereunto subscribe my name and affix the seal of the District Court of the United States for the District of Minnesota, third division.

(Seal U. S. Dist. Court, Dist. of Minnesota, third division.)

CHARLES L. SPENCER,

*Clerk of the District Court of the United States
for the District of Minnesota.*

Filed Feb. 12, 1916.

JOHN D. JORDAN, *Clerk.*

22 And thereafter the following proceedings were had in said cause in the Circuit Court of Appeals, viz:

Appearance of counsel for plaintiff in error.

United States Circuit Court of Appeals, Eighth Circuit.

E. J. LYNCH, COLLECTOR, ETC., PLAINTIFF IN ERROR,

vs.

H. C. HORNEY.

No. 4652.

The clerk will enter my appearance as counsel for the plaintiff in error.

ALFRED JACOB,

United States Attorney,

District of Minnesota, Duluth, Minn.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Feb. 22, 1916.

Appearance of Mr. Harold J. Richardson as counsel for defendant in error.

The clerk will enter my appearance as counsel for the defendant in error.

HAROLD J. RICHARDSON,
1408 Merchants Natl. Bank Bldg., St. Paul, Minnesota.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Mar. 18, 1916.

Appearance of Messrs. Clapp & Clapp as counsel for defendant in error.

23 The clerk will enter my appearance as counsel for the defendant in error.

N. H. CLAPP.
A. W. CLAPP.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Mar. 20, 1916.

Appearance of Mr. H. Oldenburg as counsel for defendant in error.

The clerk will enter my appearance as counsel for the defendant in error.

H. OLDENBURG,
Carlton, Minn.

(Endorsed:) Filed in U. S. Circuit Court of Appeals, Apr. 6, 1916.

Order of submission.

MAY TERM, 1916,
Saturday, May 13, 1916.

This cause having been called for hearing in its regular order, argument was commenced by Mr. Alfred Jaques for plaintiff in error, continued by Mr. A. W. Clapp for defendant in error, and concluded by Mr. Alfred Jaques for plaintiff in error.

Thereupon this cause was submitted to the court on the transcript of the record from said district court and the briefs of counsel filed herein.

24 *Opinion.*

United States Circuit Court of Appeals, Eighth Circuit.

E. J. LYNCH, COLLECTOR OF INTERNAL
revenue for the district of Minne-
sota, plaintiff in error,

vs.

H. C. HORNBY, DEFENDANT IN ERROR.

No. 4652, September term,
A. D. 1916.

In error to the District Court of the United States for the District of Minnesota.

Mr. Alfred Jacques, U. S. attorney, appeared for plaintiff in error. Mr. A. W. Clapp (Mr. N. H. Clapp, Mr. H. Oldenburg, and Mr. Harold J. Richardson were with him on the brief) for defendant in error.

Before Sanborn, Adams, and Carland, Circuit Judges.

Sanborn, Circuit Judge, delivered the opinion of the court.

The writ of error in this case challenges a judgment which Hornby, the plaintiff below, recovered against Lynch, the collector, for the return to him of \$171 which the collector had assessed against him as an additional income tax under the tariff act of October 3, 1912, C. 16, sec. 11, 38 Stat., 168; 3 U. S. Comp. Stat., 1913, sec. 6319, 6320, 6321, and which he had paid under protest. The facts were alleged in the complaint of Hornby and they were admitted by demurrer. They are set forth in detail and are numerous, but the result of them is that Hornby was the owner of 434 shares of the capital stock of the Cloquet Lumber Company from 1906 until 1913. That company was a corporation of Iowa which for more than a quarter of a century has been engaged in purchasing timberlands, manufacturing the timber into lumber and selling it. It had a capital stock of \$1,000,000 divided into 10,000 shares of the 35 par value of \$100 each. On March 1, 1912, by the increase of the value of its timberlands and by its business operations it had become possessed of property which was worth four times the par value of its stock, or \$4,000,000; its timber had become worth ten dollars per thousand feet and the stock of Mr. Hornby, the par value of which was \$43,400, had become worth at least \$150,000. In the year 1914 the Cloquet Company was engaged in converting its standing timber into money and distributing it among its stockholders by cutting the timber, manufacturing it into lumber, and selling the lumber. In that year it distributed to its stockholders in dividends \$650,000. Of these distributions \$240,000, or 34% of the par value of its capital stock, was derived from the net earnings and profits of the company during the current period and \$410,000 was derived from moneys realized during the year 1914 by the Cloquet Company from the conversion into money by it of property which it owned, or in which it had an interest, on March 1, 1912. Hornby received during the year 1914 \$10,416 from the distribution of these net earnings and profits of the company and \$17,794 out of the distribution of these moneys realized from the conversion into money of the property which the Cloquet Company owned or had an interest in on March 1, 1912. The property out of which the \$410,000 was realized was of the value of \$410,000 on March 1, 1912, and the conversion of it into money and the distribution thereof diminished the value of the company's property as it was on March 1, 1912, by that amount and diminished the value of Mr. Hornby's stock as it was on March 1, 1912, and increased his cash \$17,794. In his income-tax re-

turn for the year 1914 Mr. Hornby included the \$10,416 he received out of the income and profits of the Cloquet Company during that year and did not pay an income tax without protest upon a computation which included this amount, but he did not include the \$17,794 which he received out of the moneys realized in 1914 by the Cloquet Company from the conversion into money of property which it owned or had an interest in on March 1, 1913. The Commissioner of Internal Revenue deemed this \$17,794 taxable income to Mr. Hornby and on account of it levied an additional tax of \$171 which Mr. Hornby paid under protest and brought this action to recover.

Counsel for the United States complains that the complaint does not state facts sufficient to constitute a cause of action because it does not state the original cost of the timber or other property which the Cloquet Company acquired before and owned on March 1, 1913. But that omission is immaterial because it does state the value of the property which that company owned and was interested in on March 1, 1913, which was converted into money and distributed to its stockholders in 1914 and that this conversion and distribution diminished the value of its property as it was on March 1, 1913, and as it was just before the conversion and distribution by \$410,000 and diminished the value of Mr. Hornby's stock as it was on March 1, 1913, and as it was just before the sale and distribution by \$17,794. As none of the property which the Cloquet Company or Hornby held on March 1, 1913, whether it was original capital or previously earned surplus, income, gains, or profits, was intended to be made or was made taxable as income by the income-tax law of 1913, the complaint stated facts sufficient to show that this \$17,794 was not so taxable.

This case was tried in the court below and was argued and submitted to this court with the case of *Lynch v. Turrish*, the opinion in which is filed herewith. With the exception of the contention which has just been considered it presents the same questions considered and determined in that case. For the reasons stated in the opinion in *Lynch v. Turrish*, and because no income, gains, or profits accrued to Mr. Hornby during the year 1914, or at any time after March 1, 1913, by reason of the conversion into moneys and distribution in the year 1914 of that portion of the property which the Cloquet Company owned or owned an interest in on March 1, 1913, from which it realized the \$410,000 in 1914, but the effect of that conversion and distribution was simply to change the form in 1914 of a part of the property which Mr. Hornby owned on March 1, 1913, while its value remained the same, the \$17,794 which he received in dividends from that conversion and distribution was not subject to any income tax under the income-tax law of 1913, and the judgment below is affirmed.

Filed September 4, 1915.

United States Circuit Court of Appeals, Eighth Circuit.

SEPTEMBER TERM, 1916.

MONDAY, SEPTEMBER 4, 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE FOR THE
district of Minnesota, plaintiff in error,
vs.

H. C. HORNBY.

No. 4693.

In error to the District Court of the United States for the District of Minnesota.

This cause came on to be heard on the transcript of the record from the District Court of the United States for the District of Minnesota, and was argued by counsel.

On consideration whereof it is now here ordered and adjudged by this court that the judgment of the said district court in this case be, and the same is hereby, affirmed, with costs; and that H. C. Hornby have and recover against E. J. Lynch, collector of internal revenue for the district of Minnesota, the sum of twenty-two and 80/100 dollars for his costs in this behalf expended, and that the same be paid in accordance with law.

September 4, 1916.

United States Circuit Court of Appeals, Eighth Circuit.

I, John D. Jordan, clerk of the United States Circuit Court of Appeals for the Eighth Circuit, do hereby certify that the foregoing contains the transcript of the record from the District Court of the United States for the District of Minnesota as prepared and printed under the rules of the United States Circuit Court of Appeals for the Eighth Circuit, under the supervision of its clerk, and full, true, and complete copies of all the pleadings, record entries, and proceedings, including the opinion, had and filed in the United States Circuit Court of Appeals, except the full captions, titles, and endorsements omitted in pursuance of the rules of the Supreme Court of the United States, in a certain case in said Circuit Court of Appeals wherein E. J. Lynch, collector of internal revenue for the district of Minnesota, was plaintiff in error, and H. C. Hornby was defendant in error, No. 4693, as full, true, and complete, as the originals of the same remain on file and of record in my office.

I do further certify that on the sixth day of November, A. D. 1916, a mandate was issued out of said Circuit Court of Appeals in said cause directed to the judges of the District Court of the United States for the District of Minnesota.

In testimony whereof I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit at office in the city of St. Louis, Missouri, this twenty-seventh day of February, A. D. 1917.

[SEAL.]

JOHN D. JORDAN,
*Clerk of the United States Circuit Court of Appeals
 for the Eighth Circuit.*
 By E. E. KOCH, *Asst. Clerk.*

20 In the Supreme Court of the United States, October Term,
 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE,
 etc., petitioner,
 v.
 H. C. HORNBY.

No. 965.

Stipulation as to return.

It is hereby stipulated by counsel for the parties to the above-entitled cause that the certified transcript of the record herein, now on file in the office of the clerk of the Supreme Court, may be taken as the return of the clerk of the Circuit Court of Appeals for the Eighth Circuit to the writ of certiorari issued herein.

JNO. W. DAVIS,
Solicitor General.
 N. H. CLAFF,
 A. W. CLAFF,
 H. OLSENBERG,
Counsel for Respondent.

March 26, 1917.

(File 5-22.)

(Endorsed:) No. 4682. E. J. Lynch, Collector of Internal Revenue, etc., Plaintiff in Error, vs. H. C. Hornby. Stipulation as to return to writ of certiorari from Supreme Court U. S. Filed Apr. 23, 1917, E. E. Koch, clerk.

25 UNITED STATES OF AMERICA, vs.

The President of the United States of America, to the honorable the judges of the United States Circuit Court of Appeals for the Eighth Circuit, greeting:

Being informed that there is now pending before you a suit in which E. J. Lynch, collector of internal revenue for the district of Minnesota, is plaintiff in error and H. C. Hornby is defendant in error, No. 4682, which suit was removed into the said Circuit Court of Appeals by virtue of a writ of error to the District Court of the United States for the District of Minnesota, and we, being willing for certain reasons that the said cause and the record and proceed-

ings therein should be certified by the said Circuit Court of Appeals and removed into the Supreme Court of the United States, do hereby command you that you send without delay the said Supreme Court as aforesaid the record and proceedings in said cause, so that the said Supreme Court may act thereon of right and according to law ought to be done.

Witness the honorable Edward D. White, Chief Justice of the United States, the twenty-second day of March, in the year of our Lord one thousand nine hundred and seventeen.

[S^{IG}NED.]

JAMES D. MAHER,

Clerk of the Supreme Court of the United States.

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Return to writ.

UNITED STATES OF AMERICA,

Eighth Circuit, ss.

In obedience to the command of the within writ of certiorari in pursuance of the stipulation of the parties, a full, true, and complete copy of which is hereto attached, I hereby certify that the transcript of record furnished with the application for a writ of certiorari in the case of E. J. Lynch, Collector of Internal Revenue for the District of Minnesota, Plaintiff in Error, vs. H. C. Hornby, No. 4552, is a full, true, and complete transcript of all the pleadings, proceedings, and record entries in said cause as mentioned in the certificate thereto.

In testimony whereof I hereunto subscribe my name and affix the seal of the United States Circuit Court of Appeals for the Eighth Circuit, at office in the city of St. Louis, Missouri, this twenty-first day of April, A. D. 1917.

[S^{IG}NED.]

E. E. KOCH,

Clerk of the United States Circuit Court of Appeals for the Eighth Circuit.

(Indorsed:) File No. 25795. Supreme Court of the United States, No. 965, October term, 1916. E. J. Lynch, Collector of Internal Revenue, etc., vs. H. C. Hornby. Writ of certiorari. Order of the clerk, Supreme Court U. S. Received Apr. 24, 1917.

Filed Apr. 20, 1917. E. E. Koch, clerk.

30

(Indorsed:) File No. 25795. Supreme Court U. S., October term, 1916. Term No. 965. E. J. Lynch, Collector of Internal Revenue, etc., vs. H. C. Hornby. Writ of certiorari and return. Received Apr. 24, 1917.

In the Supreme Court of the United States.

OCTOBER TERM, 1916.

E. J. LYNCH, COLLECTOR OF INTERNAL REVENUE, ETC., PETITIONER, v. H. C. HORNBY.	}	No.
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT THEREOF.

The Solicitor General, on behalf of Lynch, collector, prays for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Eighth Circuit in the above-entitled cause.

QUESTION INVOLVED.

Where a company incorporated for the purpose of buying and holding timber lands and of manufacturing and selling lumber invests a part of its capital in timber lands or in timber on them ("stumpage"), and in the regular course of business uses said timber for producing lumber, charging against the manufacturing cost of the lumber the full value of the stumpage, and distributes the entire proceeds of the sale of its lumber, less ordinary expenses, to its stockholders, informing them that part is derived from the

net profits, charging manufacturing with the full value of the timber, and part from the conversion of the timber itself, is the amount so claimed to be derived from the conversion of the timber, or any part thereof (and, if so, what part) income of the stockholders within the meaning and intent of the act of October 3, 1913, 38 Stat. 166?

STATEMENT OF CASE.

The Cloquet Lumber Company was incorporated under the laws of Iowa, with power to buy and hold timber lands and to manufacture and sell lumber, having an authorized and paid-in capital stock of \$1,000,000, divided into 10,000 shares (R. 6). Prior to March 1, 1913, the respondent, Hornby, became the owner of 434 shares (*ib.*), and the timber of the company had very greatly appreciated in value, being worth \$10 a thousand feet, board measure (R. 6, 7). In the year 1914 the company received from the proceeds of lumber sales, deducting ordinary expenses, the sum of \$652,318.27 (R. 8, 10). Of this, it is admitted that \$242,318.27 was ordinary net income, or profits. The \$410,000 remaining is claimed not to be income for this reason. (The transaction with the Johnson-Wentworth Company is not touched on, as it does not affect the principle.) Whenever the company used its own timber, although, of course, it paid nothing for it, it charged lumber manufacturing cost, with the full market value of it, as of March 1, 1913 (thus bringing the admitted net profits on the lumber business down

to \$242,318.27), and then treated the value of the timber so converted as a separate item, claiming that it was a distribution of capital and not a part of the gross income received from the lumber business (R. 8, 9, 10). This point is important, for the Court of Appeals entirely misconceived the transaction, treating it as a conversion of timber into money, and therefore governed by its decision in the *Turrish* case. While it is true that the complaint at the outset of paragraph 9 states that the \$410,000 was the proceeds of the conversion of standing timber, or stumpage, into money (R. 8), the following later statement makes clear the meaning:

The net profits of said company from its manufacturing and selling operations in any calendar year is therefore arrived at on the basis of charging as an element in manufacturing cost, the actual value (as of March 1, 1913) of the standing timber owned by the said company and consumed by it during the year, to wit, at \$10 per thousand feet, board measure, straight and sound scale as above alleged, and the total amount realized in each year by said company *from the sale of lumber* over and above the net profits on said operations, computed as hereinabove stated, is the amount realized and received by said company in that year from said conversion of its standing timber. (R. 8, 9; see also R. 10 at bottom.) (Italics mine.)

Indeed the *Hornby* case was selected by the lumber interests just because it differed from the *Turrish* case in this manner.

In 1914 the Cloquet Company distributed the above \$650,000 to its stockholders, informing them that \$240,000 of the amount was net profits, but that \$410,000 was derived from the conversion of capital owned prior to March 1, 1913 (R. 11). Hornby received on his stock the sum of \$28,210 (ib.). Of this amount he returned as income \$10,416, but did not return \$17,794, being his proportionate share of the \$410,000 claimed to arise from conversion of capital, and the present case turns on the question whether this amount or any part thereof was income to him.

The Court of Appeals merely followed its decision in the *Turkish* case and held that none of it was income (286 Fed. 661).

REASONS FOR THE ALLOWANCE OF THE WRIT.

1. The case is of great public importance because of the large effect its decision will have on the revenues of the Government as determining the proper method of income taxation on stockholders in companies which manufacture and sell lumber, using their own timber, and distribute the entire proceeds, less ordinary expenses, as dividends among their stockholders.

2. The judgment of the Court of Appeals rests on its own decision in *Sargent Land Co. v. Von Baumbach*, 207 Fed. 423, which was reversed by this court on January 15 last (No. 286).

3. A stockholder has no income from shares of stock in a corporation until dividends are declared, and in this case the dividend paid to Hornby was an ordinary cash dividend arising out of the regular operations of the company.

4. The decision of the Court of Appeals confuses capital and income and either treats the tax as one on capital or holds that no income can accrue under any circumstances where capital is converted.

5. The decision of the Court of Appeals is contrary to the principles laid down by this court in *Brushaber v. Union Pacific R. R.*, 240 U. S. 1, and *Stanton v. Baltic Mining Co.*, 240 U. S. 103.

BRIEF IN SUPPORT OF PETITION.

1. This case and its companion, *Lynch v. Turrish* (in which application for a writ of certiorari is submitted at the same time), have been selected by the great lumber interests of the West and Northwest as test cases to determine the proper method of income taxation upon stockholders in lumber companies. The *Turrish* case presents the phase of an investment in timber lands and stumpage with the intention of merely allowing the timber to appreciate in value from natural causes and of selling it when conditions appear favorable. The *Hornby* case presents the phase of dividends from companies which, while owning their own timber lands and stumpage, are engaged in converting the timber into lumber, using continuously in this process their own timber, and thus, it is claimed, depleting to that extent their capital. The cases are therefore of great public importance, not only because of the principles of law involved, but also because of their large bearing on the revenues of the Government.

2. Even if the matter is looked at from the point of view of the corporation instead of the stockholder,

the decision of this court on January 15 last in *Von Baumbach v. Sargent Land Company* shows that the entire amount received by the company from the sale of its lumber, including that portion estimated to arise from the timber, was its gross income, and that the depletion of its capital caused by the removal of the timber could not be deducted as depreciation unless an amount was actually set aside to plant new trees. A timber plantation does not differ in this respect from a mine, since the very object of the enterprise is to convert capital into income by converting the trees into lumber. Mr. Morawetz, in his work on *Private Corporations* (2 ed.), after pointing out that dividends may not ordinarily be paid out of capital, thus states the principles applicable to the present case (sec. 442):

SEC. 442. *Different Rule applicable to Mining Companies.*—The rule stated in the preceding section has no application to a corporation whose sole purpose is to invest its capital in a specific piece of property like a mine, and afterwards to consume the property or extract its value at a profit. The capital of a mining company is not designed to be used, like that of a banking or manufacturing company, in carrying on business permanently. The working of a mine necessarily causes it to become exhausted and to depreciate in value, and this depreciation cannot be repaired. There would be no object in accumulating the money obtained by the company through working the mine, so as to keep up the original amount of capital. It is implied from the

character of the speculation of a mining company, that the income derived from working the mine shall be distributed among the shareholders as dividends, after deducting the expenses, and making reasonable provision for contingencies. * * *

A case precisely similar to the *Hornby* case arose in *Kauri Timber Company, Limited, v. Commissioner of Taxes* (1913), A. C. 771, where it was held by the Privy Council that a company cutting, milling, and selling timber could not deduct from its gross proceeds, for the purpose of determining its net income, the value of the standing timber cut. While the case arose under the New Zealand statutes, it was decided on general principles. The court said (p. 777):

With regard to the decided cases, the general principle as to the impropriety of treating a quota of invested capital, or of the corpus of the subject acquired, as a proper item of debit from annual profits received, can no longer be considered to be in doubt.

After referring to *Coltness Iron Co. v. Black*, 6 App. Cas. 315, the court said (p. 778):

The language of the learned Lord had, of course, specific reference to the expressions used in the English income taxing statutes, but the principle to be applied is clearly a general one to the effect that the consumption of capital cannot be treated in the ascertainment of profits as a revenue debit.

Again, on page 778:

The law—so clearly settled with regard to the working of coal and of nitrates, and settled upon a broad general principle—is in no way different when it comes to be applied to timber-bearing lands.

And finally, on pages 780 and 781:

Nor is it necessary to add that this mode of treating timber or mineral for taxation purposes contains nothing novel. For it has long been the law of the United Kingdom that the exhaustion of capital, however it might be treated on strict actuarial principles or according to certain principles of economics, may for the purposes of taxation be treated as profit. That profit may be temporary, and so when it ceases the capital may be gone, and with the going of the capital there will also go the subject and the possibility of the tax. * * *

The cases of *Stevens v. Hudson's Bay Co.*, 101 Law Times Rep. 96, and *Tebrau Rubber Syndicate v. Farmer*, 47 Scot. L. R. 816, relied upon by the Court of Appeals (236 Fed. 660), are distinguishable because in neither case was it the company's business to convert its capital into income.

The argument of the Court of Appeals would lead to the conclusion that no income at all accrues from the use of raw materials if they happen to be owned by the manufacturer. For instance, if the Cloquet Company had bought its timber, it could have charged the cost as an expense, but the vendor would have

had to account for the amount received as income, so that the Government would have received the tax it is justly entitled to. This income, however, and the tax thereon, is lost, according to the Court of Appeals, because the Cloquet Company owned the timber. If, therefore, a person own and control all the processes of manufacturing from the extraction of the raw material up to the sale of the finished article to the consumer, the income tax is due only on the net receipts of the last transaction after charging against it all the profits of the prior transactions, since each one of those transactions represents a conversion of capital, either into another form or to another place. All that a gold-mining company need do to evade the effect of the decision of this court in *Stratton's Independence, Limited, v. Howbert*, 231 U. S. 399, is to manufacture its gold into ornaments. Then the entire value of the gold in the mine may be charged to the manufacturing cost of the ornaments, and income tax paid only on the balance.

Principles leading to such conclusions cannot be sound. Clearly the entire receipts of the Cloquet Company from its sales of lumber were its gross income for the year in which they were received. To ascertain the statutory net income, only those items specified in the act could be deducted. *Anderson v. Forty-two Broadway Co.*, 239 U. S. 69, 72. "A reasonable allowance for depreciation" is the only one that can possibly fit this case. Depletion of capital cannot be deducted under this head, however (*Von Baum-*

bach v. Sargent Land Co., supra), and clearly the conversion of the timber into lumber was a depletion of capital.

3. In so far as Hornby, the stockholder is concerned, he had no rights in the timber owned by the company but only a right to dividends declared by it from its operations. *Gibbons v. Mahon*, 136 U. S. 549; *Humphrey v. McKissock*, 140 U. S. 304, 312; *Savings Bank of Danbury v. Loewe*, No. 713 this term, decided January 8. The entire amount received by him was distributed by the directors as a dividend from the ordinary operations of the company (R. 11), and the notification that part of it came from the use of the company's own timber could not prevent that part from being his income "derived from dividends." If this be not true, it will be necessary for the Government to analyze to the root the sources of every dividend received, and attempt to distinguish its different elements.

4 and 5. In addition, reasons Nos. 4 and 5 advanced for the allowance of the writ in the *Turkish* case are referred to as part of this petition as though incorporated, since they have the same application to this case as they have to that.

CONCLUSION.

It is submitted that the writ should issue as prayed so that this court may give plenary consideration to the important questions here involved.

JOHN W. DAVIS,
Solicitor General.

FEBRUARY, 1917.